

# Internal Revenue Service

Department of the Treasury

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Person to Contact:

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Date:

November 27, 2000

## Legend

Taxpayer =

Trust 1 =

Trustee =

Property =

Parcel A =

Parcel B =

a =

b =

c =

Date 1 =

Grantee =

River =

d =

e =

f =

Trust 2 =

PLR-101092-00

State =

Dear Sir:

We received your letter, dated January 4, 2000, requesting rulings regarding application of the rules for a qualified personal residence trust in § 2702 of the Internal Revenue Code. This letter responds to your request.

The facts and representations submitted are summarized as follows: Taxpayer proposes to create Trust 1. The terms of Trust 1 are intended to satisfy the requirements for a qualified personal residence trust found in § 25.2702-5(c). Taxpayer proposes to transfer Property, consisting of Parcel A and Parcel B, to Trust 1.

Parcel A of Property consists of a acres of land that includes Taxpayer's vacation home, a detached garage with an apartment above the garage, a one-bedroom cabin with a loft, a tennis court and a Jacuzzi with an outdoor shower. A maintenance person lives in the apartment above the garage rent-free for a portion of the year. The maintenance person receives compensation for maintenance and housekeeping responsibilities. Taxpayer has constructed the improvements on Parcel A since he purchased the land approximately b years ago. Parcel B of Property consists of c acres of land and no improvements. Other properties in the area are of a similar nature and generally consist of greater acreage than Property.

Taxpayer and Taxpayer's spouse have used Property, consisting of both parcels, as a vacation residence for b years. Property is used as a vacation residence for more than e days per year. Taxpayer has never used Property for any purpose other than a vacation residence. Taxpayer represents that no individual, other than Taxpayer, has the right to use or occupy Property and that no commercial activity is conducted on Property.

Property, including Parcel A and Parcel B, is subject to a Deed of Conservation Easement (Easement) dated Date 1 between Taxpayer, as grantor, and Grantee. For purposes of the Easement, Parcel A and Parcel B, together, comprise a single piece of property. Taxpayer represents that most of the land that is contiguous to Property is subject to similar conservation easements. Paragraph 1 of Exhibit C of the Easement expressly prohibits the division, subdivision or de facto subdivision of Property, except as provided in Paragraph 5 of Exhibit B.

Article 1, Section 1.1 of Trust 1 provides that Taxpayer declares that he has transferred and delivered to Trustee in trust the property described in Exhibit A, which property constitutes an interest in a personal residence, and such other property as may be subject to this document.

According to Article 2, Section 2.2, the fixed term of Taxpayer's interest means a period of f years, commencing with the date on which either (i) an interest in a personal residence or (ii) cash for the purchase of an interest in a personal residence (as specified in § 25.2702-5(c)(5)(ii)(A)(iii)) is transferred to the trustee.

PLR-101092-00

Under Article 2, Section 2.3.b, any net income of the trust estate must be distributed to Taxpayer not less frequently than annually. No distributions of income or principal shall be made to or for the benefit of any person other than Taxpayer; provided, however, that this sentence shall not be construed as preventing the payment of expenses properly chargeable to the trust estate.

Article 2, Section 2.3.c provides that commutation of Taxpayer's interest hereunder is prohibited.

According to Article 2, Section 2.3.d, the trust may not hold any assets other than (i) one residence or an interest therein to be used or held for use (within the meaning of § 25.2702-5(c)(7)(i)) as a personal residence of Taxpayer; (ii) improvements to a residence provided that the residence, as improved, meets the requirements of a personal residence; (iii) one or more policies of insurance or an interest therein insuring the trust's interest in a residence against damage or destruction; (iv) and additions of cash, limited as set forth below, to be held in separate accounts known as the Expense and Improvement Account (to be used for certain expenses and improvements associated with the trust's ownership of an interest in a residence as provided in Paragraph 2.3.f.), the Sales Proceeds Account (to hold the proceeds from any sale of the trust's interest in a residence), and the Insurance Proceeds Account (to hold proceeds of insurance payable to the trust as a result of damage to or destruction of a residence). In no event may additions of cash be made hereunder unless the one residence or interest therein constitutes a personal residence of Taxpayer.

Under Article 2, Section 2.3.f, the trustee may hold in the Expense and Improvement Account cash in an amount which, when added to the cash already held, does not exceed the amount required for (i) payment of trust expenses (including mortgage payments) already incurred or reasonably expected to be paid by the trust within six months from the date the addition is made, (ii) improvements to a residence to be paid by the trust within six months from the date the addition is made (provided the residence, as improved, will meet the requirements of a personal residence), and (iii) the purchase by the trust of a residence to replace another residence, within three months from the date the addition is made, provided, however, that the trustee has previously entered into a contract to purchase such replacement residence (collectively referred to as the "Maximum Expense Reserve"), and such cash may be used for any such purposes. The trustee shall determine, not less frequently than quarterly, the amounts held by the trust in the Expense and Improvement Account in excess of the Maximum Expenses Reserve and shall distribute such amounts to the Taxpayer at least quarterly.

Article 2, Section 2.3.k provides that this trust shall cease to be a qualified personal residence trust in whole or in part as follows: (i) With respect to the entire trust estate upon a residence ceasing to be used or held for use as a personal residence of Taxpayer as provided in § 25.2702-5(c)(7). (ii) With respect to the entire trust estate upon the first to occur of (A) the date that is two years after the date damage or destruction renders a residence unusable as a residence, (B) the expiration of the fixed term of Taxpayer's interest, and (c) Taxpayer's death, unless, prior to the occurrence of such events, replacement of or repairs to the residence are completed or a new residence is acquired by the trust. (iii) With respect to all proceeds of sale held in the

PLR-101092-00

Sales Proceeds Account as the result of a sale of a residence, not later than the first to occur of (A) the date that is two years after the date of the sale of the residence, (B) the expiration of the fixed term of Taxpayer's interest, (C) Taxpayer's death, and (D) the date on which a new residence is acquired by the trust. (iv) With respect to all insurance proceeds held in the Insurance Proceeds Account as the result of damage, destruction or involuntary conversion of a residence, not later than the first to occur of (A) the date that is two years after the date of such damage, destruction or involuntary conversion, (B) the date on which the replacement or repairs to the residence are completed or a new residence is acquired by the trust, (C) the expiration of the fixed term of Taxpayer's interest, and (D) Taxpayer's death.

Under Article 2, Section 2.3.I, within thirty days after this trust ceases to be a qualified personal residence trust with respect to all or any portion of the trust estate for any reason other than the expiration of the fixed term of Taxpayer's interest or Taxpayer's death, as the case may be, the assets with respect to which this trust has ceased to be a qualified personal residence trust (and which are not, in the independent trustee's discretion, distributed to Taxpayer) shall be converted to and held for the balance of the fixed term of Taxpayer's interest in a separate trust meeting the requirements of a qualified annuity interest as set forth in this paragraph 2.3.I. The provisions of § 25.2702-3 are incorporated in Article 2, Section 2.3.I(iii) to establish and to administer the trust share as a qualified annuity interest.

According to Article 2, Section 2.4, if Taxpayer dies before the expiration of the fixed term of Taxpayer's interest, then upon his death he may appoint all or any portion of the trust estate on any terms and conditions, either outright or in trust, in favor of any one or more persons or entities, including Taxpayer's estate. Notwithstanding the preceding sentence, if a separate trust meeting the requirements of a qualified annuity interest is being administered hereunder, Taxpayer's general power of appointment described in the preceding sentence is limited to and exercisable only over a portion of the separate trust bearing the same ratio to the total fair market value of the separate trust, as the value is finally determined for federal estate tax purposes, as the value of the principal includible in Taxpayer's gross estate for federal estate tax purposes bears to the entire value of the principal thereof. The portion of the trust estate, if any, which Taxpayer has no power to appoint shall be distributed as provided in Paragraph 2.5.b. Any portion of the trust estate which Taxpayer may appoint but does not shall be distributed to the trustee of Trust 2, as in force on the date of Taxpayer's death, giving effect to any exercise of a power of appointment (including the power of amendment) or, if Trust 2 is not then in existence, the portion will be distributed to Taxpayer's estate.

Article 2, Section 2.5 provides that if Taxpayer survives the expiration of the fixed term of Taxpayer's interest, the trust estate shall be distributed upon such expiration as follows: (a) cash held by the trustee in the Expense and Improvement Account, if any, other than cash used to pay trust expenses due and payable on the date of termination (including expenses directly related to termination) shall be distributed to Taxpayer within thirty days of the date of termination; (b) the balance of the trust estate shall, subject to the provisions of paragraph 2.6, be distributed in equal shares to Taxpayer's then living children or, if none, to Taxpayer's then living issue, by right of representation. If no such issue are then living, such property will be distributed as provided in paragraph 2.8.

PLR-101092-00

Under Article 2, Section 2.7, if Taxpayer survives the expiration of the fixed term of Taxpayer's interest, Taxpayer and, from and after Taxpayer's death, his spouse, shall have the right to lease the residence from the trusts owning interests therein under this document (including any successor in interest to the trusts as the result of the distribution of an interest in the residence in accordance with the terms of this document) for such term of years, including options to renew, as Taxpayer and, from and after Taxpayer's death, his spouse, from time to time determine. Taxpayer and, from and after Taxpayer's death, his spouse, shall be charged fair market rent during the periods he or she leases the residence.

Article 2, Section 2.8, provides if Taxpayer survives the expiration of the fixed term of Taxpayer's interest, then at any time thereafter that property is directed to be distributed to Taxpayer's heirs, whose respective identities and shares shall be determined at the time property is directed to be distributed as provided in this paragraph as though the deaths of Taxpayer and his spouse occurred immediately following such event, and according to the State laws of intestate succession then in force relating to separate property not acquired from a parent, grandparent or previously deceased spouse. However, if after six months of reasonable search following the occurrence of such event, the trustee is unable to identify and locate any such heirs of Taxpayer, the property distributable to Taxpayer's heirs shall instead be distributed to one or more charities selected by the independent trustee, subject to the provisions of paragraph 2.6, as if each charity so selected were a natural person over the age of twenty-one.

Article 5, Section 5.11 provides except as provided in paragraph 2.4, neither Taxpayer, his spouse, nor an entity controlled (as that term is defined in §§ 25.2701-2(b)(5)(ii) and (iii)) by Taxpayer or his spouse may directly or indirectly purchase, or otherwise reacquire, any interest in any residence included in the trust estate or reacquire any or all of the principal of any trust by substituting assets of equivalent value during the fixed term of Taxpayer's interest or at any time thereafter during which the residence is held by a trust which is a grantor trust as to Taxpayer (under §§ 671-678).

You have requested the following rulings: (1) Property constitutes a personal residence within the meaning of § 25.2702-5(c)(2); (2) Trust 1 will constitute a qualified personal residence trust within the meaning of § 25.2702-5(c); and, therefore, (3) Trust 1 will satisfy the exception to § 2702(a)(2) set forth in § 2702(a)(3)(A)(ii).

Section 2702(a)(1) provides that solely for purposes of determining whether a transfer of an interest in trust to (or for the benefit of) a member of the transferor's family is a gift (and the value of such transfer), the value of any interest in the trust retained by the transferor or any applicable family member (as defined in § 2701(e)(2)) is determined as provided in § 2702(a)(2).

Section 2702(a)(2) provides that the value of any retained interest that is not a qualified interest is treated as being zero. The value of any retained interest which is a qualified interest shall be determined under § 7520.

PLR-101092-00

Section 2702(a)(3)(A)(ii) provides that § 2702(a)(2) does not apply to any transfer if the transfer involves the transfer of an interest in trust all the property in which consists of a residence to be used as a personal residence by persons holding term interests in such trust.

Section 25.2702-5(a)(1) of the Gift Tax Regulations provides, in part, that § 2702 does not apply to a transfer in trust meeting the requirements of this section. A transfer in trust meets the requirements of this section only if the trust is a personal residence trust (as defined in paragraph (b) of this section). A trust meeting the requirements of a qualified personal residence trust (as defined in § 25.2702-5(c)) is treated as a personal resident trust.

Section 25.2702-5(c)(1) provides that a qualified personal residence trust is a trust meeting all the requirements of § 25.2702-5(c). These requirements must be met by provisions in the governing instrument, and these governing instrument provisions must by their terms continue in effect during the existence of any term interest in the trust.

Section 25.2702-5(c)(2)(i) provides that for the purposes of § 25.2702-5(c), a personal residence of a term holder is either (A) the principal residence of the term holder (within the meaning of § 1034); (B) one other residence of the term holder (within the meaning of § 280A(d)(1) but without regard to § 280A(d)(2)); or (C) an undivided fractional interest in either.

Section 280A(d)(1) provides that a taxpayer uses a dwelling unit during the taxable year as a residence if he uses such unit (or portion thereof) for personal purposes for a number of days which exceeds the greater of (A) 14 days, or (B) 10 percent of the number of days during such year for which such unit is rented at a fair rental.

Section 25.2702-5(c)(2)(ii) provides that a personal residence may include appurtenant structures used by the term holder for residential purposes and adjacent land not in excess of that which is reasonably appropriate for residential purposes (taking into account the residence's size and location). The fact that a residence is subject to a mortgage does not affect its status as a personal residence. The term personal residence does not include any personal property (e.g., household furnishings).

Section 25.2702-5(c)(3) provides that the governing instrument must require that income of the trust be distributed to the term holder not less frequently than annually.

Section 25.2702-5(c)(4) provides that the governing instrument must prohibit distributions of corpus to any beneficiary other than the transferor prior to the expiration of the retained term interest.

Section 25.2702-5(c)(5) provides that, in general, except as otherwise provided in paragraphs (c)(5)(ii) and (c)(8) of this section, the governing instrument of a qualified personal residence trust must prohibit the trust from holding, for the entire term of the trust, any asset other than one residence to be used or held for use (within the meaning

PLR-101092-00

of paragraph (c)(7)(i) of this section) as a personal residence of the term holder (the "residence"). Under § 25.2702-5(c)(5)(ii), the trust may hold certain assets listed in that section in addition to the personal residence.

Section 25.2702-5(c)(6) provides that the governing instrument must prohibit commutation (prepayment) of the term holder's interest.

Section 25.2702-5(c)(7)(i) provides that the governing instrument must provide that a trust ceases to be a qualified personal residence trust if the residence ceases to be used or held for use as a personal residence of the term holder. A residence is held for use as a personal residence of the term holder so long as the residence is not occupied by any other person (other than the spouse or a dependent of the term holder) and is available at all times for use by the term holder as a personal residence.

Section 25.2702-5(c)(8) provides that (i) the governing instrument must provide that, within thirty days after the date on which the trust has ceased to be a qualified personal residence trust with respect to certain assets, either, (A) the assets be distributed outright to the term holder; (B) the assets be converted to and held for the balance of the term holder's term in a separate share of the trust meeting the requirements of a qualified annuity interest; or (C) in the trustee's sole discretion, the trustee may elect to comply with either paragraph (C)(8)(i)(A) or (B) of this section pursuant to their terms; and (ii)(A) for assets subject to this paragraph (c)(8) to be converted to and held as a qualified annuity interest, the governing instrument must contain all the provisions required by § 25.2702-3 with respect to a qualified annuity interest.

Section 25.2702-5(c)(9) provides that the governing instrument must prohibit the trust from selling or transferring the residence, directly or indirectly, to the grantor, the grantor's spouse, or an entity controlled by the grantor or the grantor's spouse during the retained term interest of the trust or at any time after the retained term interest that the trust is a grantor trust.

Based on the facts and representations submitted, we conclude that Property is a personal residence within the meaning of § 2702(a)(3)(A)(ii) and § 25.2702-5(c)(2) and all the improvements are not in excess of that which is reasonably appropriate for residential purposes (taking into account the residence's size and location). In addition, we conclude that Trust 1 contains all provisions required by § 25.2702-5(c) and thus meets the requirements of a qualified personal residence trust. Therefore, we conclude that under § 25.2702-5(a), Trust 1 will satisfy the exception to § 2702(a)(2) set forth in § 2702(a)(3)(A)(ii).

This ruling is based on the facts presented and the applicable law (including restrictive covenants) in effect on the date of this letter. If there is a change in material fact or law (local or federal) before the transactions considered in this ruling take effect, the ruling will have no force or effect.

A copy of this letter should be attached to any gift, estate or generation-skipping transfer tax returns that you may file relating to this matter. A copy is enclosed for that purpose. Except as specifically ruled herein, we express or imply no opinion on the

PLR-101092-00

federal tax consequences of the transaction under the cited provisions or under any other provisions of the Code.

This ruling is directed only to the taxpayer(s) requesting it. Section 6110(k)(3) provides that it may not be used or cited as precedent.

Sincerely,

Christine E. Ellison

Christine E. Ellison  
Chief, Branch 7  
Office of the Associate Chief Counsel  
(Passthroughs and Special Industries)

Enclosure

Copy of this letter

Copy for section 6110 purposes